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No. 81-523

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

v.

FRANCHISE TAX BOARD,

Appellee.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA, FOR THE FIRST APPELLATE DISTRICT

APPELLEE'S BRIEF ON THE MERITS

GEORGE DEUKMEJIAN
Attorney General
NEAL J. GOEAR
Deputy Attorney General
110 West A Street, Ste 700
San Diego, California 92101
(714) 237-7308

Counsel for Appellee

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III

CCA HAS NOT SHOWN DISTORTION BY THE FORMULA

CCA advances three arguments in support of its position that the use of the unitary business principle by California in this case results in substantial misattribution of income in violation of the Due Process Clause. First, it argues that formula apportionment attributes significantly more income to California than was determined for federal income tax purposes by applying the "sophisticated" accounting techniques prescribed by the Internal Revenue Service. Second, it argues that there are significant differences in wage rates between the United States and foreign countries resulting in misapportionment of income. Finally, it argues that profitability of foreign operations, expected and actual, is higher and this fact is not reflected

in the formula.

CCA's failure to set out any facts pertaining to these arguments in its Statement of the Case should cause peremptory rejection of these arguments. Additionally, examination of each of the arguments and the evidence submitted in support of them demonstrates that CCA has not established that any misattribution of income occurs.

A. Separate Accounting Data Does Not Impeach the Formula

The use of separate accounting data to impeach formula results was recently rejected by the court in Exxon.

> "As this court has on several occasions recognized, a company's internal accounting techniques are not binding on a State for tax purposes. For example, in Butler Bros. v. McColgan, supra, an interstate business challenged the application of the California apportionment statute. The company was engaged in the wholesale dry goods and general merchandise business as a middleman,and it had distributing

houses in seven States, including one in California. Each house maintained stocks of goods, had a cognizable territory, had its own sales force, did its own solicitation of sales, made its own credit and collection arrangements, and kept its own books. There was, however, a central buying division that was able to purchase goods for resale at a lower price. The company used 'recognized accounting principles,' [citation] to allocate all costs and charges to each house, with certain centralized expenses allocated among the houses. Based on that 'separate accounting system,' [citation] the business asserted there was no net income in California.

"We concluded that California could constitutionally apply its apportionment formula to the company's total net income to establish taxable income, rather than being limited to the income shown by the taxpayer's accounting methods to be attributable to the one house in that State. The company had the 'distinct burden of showing by "clear and cogent evidence" that it results in extraterritorial values being taxed,'[quoting Norfolk and Western R. Co. v. North Carolina 297 U.S. 682] and the taxpayer's accounting evidence was insufficient to meet that burden.

"'[W]e need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extra-territorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders . . . . That may be due to the fact, as stated by Mr. Justice Brandeis in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, that a State in attempting to place upon a business extending into several States "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Furthermore, the particular system used may not reveal the facts basic to the State's determination. [Citation.] In either aspect of the matter, the results of the accounting system employed by appellant do not impeach the validity or propriety of the formula which California has applied here.'"
(Exxon Corp. v. Wisconsin, supra, 447 U.S. 207, 221-222.)

Evidence of the merit of the Court's analysis exists both in a general

context and in the specifics of this case. The General Accounting Office (GAO) has recently released a study of the Internal Revenue Service's administration of the arm's-length standard and found:

> "Multinational corporations have both the incentive and the opportunity to shift income between jurisdictions to take advantage of disparate corporate tax rates. One incentive is minimization of taxes. The opportunity lies in the pricing of interorganizational transactions. Obviously, possession of incentive and opportunity does not axiomatically lead to abuse--but to tax administrators, American and foreign, it represents a vulnerability to guard against.
>
> "IRS, however, has not yet developed baseline information on the incidence and magnitude of multinational corporation noncompliance in terms of improper shifting of income. Thus, IRS has no sound basis for determining the amount of audit resources to be assigned to address the problem, nor for gauging the success of those resources that are applied to it.
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> "Further, IRS enforcement difficulties are compounded by

> the complexities involved in measuring the amount of income misallocated in those instances where this is believed to have occurred. Ideally, interorganizational pricing is to be adjusted to that for similar transactions between unrelated parties--the so-called 'arm's length standard.'
>
> "However, in the modern economic system of multinational corporate business, a true arm's length price can rarely be identified. When an arm's length price cannot be identified, Department of Treasury regulations for Internal Revenue Code Section 482 provide both the corporate taxpayer and the IRS examiner some guidance for arriving at a constructed price. The regulations and the resulting enforcement process, however,create an unacceptable level of uncertainty and a significant administrative burden both for corporate taxpayers and IRS examiners."
> (Report to the Chairman, House Committee on Ways and Means by the Comptroller General, Sept. 30, 1981, pp. 24, 53-54.)

In at least three cases, Bass, Butler Bros. and Exxon, this Court has sustained a state's attribution of income to activities in that state even though the company's separate accounting (federal

tax return) showed that it earned no net income in that state.

For a further comparison of the unitary method and the so-called "arm's length" standard and, specifically, the inadequacies of the arm's-length method, see "Multinational Corporation and Income Allocation Under Section 482 of the Internal Revenue Code," 89 Harvard Law Review 1202 (1976) and the Harley Treatise, appendix E hereto.

In the case at bar, the parties have stipulated to the accuracy of the data contained in a number of exhibits filed with the California courts. CCA argues that this separate accounting data should be controlling in determining the amount of its California income. Similar stipulations and arguments were specifically made in Butler Bros., supra, and in many other cases and have not been found controlling. Examination of the

documents and the stipulation in this case discloses why they are not.

CCA was not fully compensated for various services rendered to and benefits it conferred upon its foreign subsidiaries. Specifically, CCA stipulated that the value of many such services could not be ascertained; reimbursement received under some Technical Service Agreements was only to the extent allowed by the foreign governments; used equipment was sold at book, not fair market value; CCA brokeraged equipment at a fee less than would be charged by a third party; no fees were paid for loan guarantees; interest paid to CCA by its subsidiaries was apparently far below normal interest rates; other services were provided without being paid for. (See pp. 32-35, supra.) There were

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substantial amounts of Subpart F income.[23] (J.A.:Ex p. 7.)

In sum, CCA has not established that net income either shown in its separate accounting records or reported for U.S. income tax purposes accurately reflects the many contributions made by CCA to its subsidiaries, but on the contrary, substantial contributions by CCA are not reflected accurately or at all.

Further, even accepting CCA's separate accounting figures, the formula only apportions less than .01 more of the unitary worldwide net income to California over the .07 which CCA concedes that

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23. Subpart F income is determined under Internal Revenue Code, sections 951-964. In general it is income assigned by a corporate group to a controlled foreign corporation which is redetermined for federal purposes to be taxable to the parent company in the United States. Appellant, in its presentation on pages 16 and 17, has not included this income in its calculations of U.S. source income.

California may tax. (See pp. 36-37, supra.)

B. Differing Wage Rates and Rates of Return Do Not Impeach the Formula

The second and third arguments advanced by CCA in support of its misattribution of income arguments are dependent upon separate accounting data for their analysis. Such data has already been shown to be inaccurate and in any event, inappropriate for use in state tax on income of a unitary business. Furthermore, even assuming arguendo the separate results of the various entities provided valid data for comparative purposes, these arguments fail because the premise on which they are based is false and because CCA has not offered any supporting relevant data.

The premise on which these arguments is based is that a dollar of payroll or property expended or used in one state, and a dollar of sales realized

in one state, typically produced roughly the same amount of income as a dollar so spent or sales made in other states. (J.S. p. 17.)

This premise is false, as both the California courts and this Court have recognized.

> "In the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income . . . but its propriety in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process." (John Deere Plow Co. of Moline v. Franchise Tax Board, 38 Cal.2d 214, app.dis. 343 U.S. 939.)

Formula apportionment does not assume that a dollar spent in Latin America

had the same value as a dollar spent in California, or that a dollar in wages has some relative productivity as a dollar of property. Property, labor and sales all contribute to the ultimate net income of a business. A state provides services to protect property and workers as well as sales, which would have some rational relationship to the quantities of property, labor and sales activity present in the taxing state. A unitary business may have none to a great deal of any of the three factors, depending on how and where a business operates.

In support of its wage differential argument, CCA submitted evidence to the California courts that the average hourly wages paid in various countries were less than those paid in the United States, both absolute and when adjusted for productivity. But the data submitted and studies referred to involve a variety of

years, none of which is involved in this appeal.

Where machinery is automated, the number of workers (and wages) will be reduced substantially, but a single machine operator will probably be more highly paid and (together with his machine) will produce more. A research facility with many expensive scientists will raise the wage factor substantially wherever it is located; but it will produce no sales there. The three factors are interdependent and cannot be analyzed separately. Nothing is proven by simply comparing wage rates in one place to those in another.[24/]

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24. The wage figures which CCA tries to use are in part just general statistics by countries which have not been shown to apply to CCA. CCA's own figures are for different years from those in issue. FTB disputes the correctness and applicability here of such figures and the testimony on which they are based. Since the California courts ruled against CCA they may not be treated as correct on appeal.

As this Court stated in Norfolk & W. R. Co. v. North Carolina, supra, 297 U.S. 682, in the context of a different apportionment formula, but the same logical consideration:

> "The implications of the formula being what they are, a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. Its evidence to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal." (Id. at p. 688, emphasis added.)

The third argument advanced by CCA in support of its misattribution theory is that the expected and actual rate of return on foreign investments is higher than the return on United States investments.

The use of the return-on-investment analysis for foreign subsidiaries was subject to criticism in a Harvard Business Review article by Sidney M. Robbins and Robert B. Stobaugh entitled "The Bent Measuring Stick for Foreign Subsidiaries."

(Sept-Oct 1973, p. 80.) The article was directed to the problem of evaluating management performance, but is equally applicable to the present setting.

> "[T]heir underlying assumption typically is that a subsidiary can can be reviewed by using a companywide return-on-investment (ROI) criterion, with only a few necessary adjustments. Such an approach not only neglects significant aspects of subsidiary operations but also fails to consider the reasons for which the subsidiary was originally founded.25/

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25. "The use of an enterprisewide criterion such as return on investment as a yardstick against which to measure performance implies that the financial statements of a subsidiary reflect its performance. However, to do so accurately, these statements must be adjusted to take into account the extent to which the subsidiary influences the profits of the other units in the system. Yet any enterprise attempting to make such adjustments encounters acute complexities."("The Bent Measuring Stick . . .", supra, at p. 83.) Fn. cont'd

The investment return analysis

ignores the substantial contributions by the
the parent of a unitary business to the

Fn. 25 cont'd

Such adjustments have not been made by CCA and probably could not be made.

Companies make investments in foreign operations for long-range strategic considerations,

> [H]owever, they tend to forget this fact when subsequently evaluating their foreign subsidiaries' performance. The system in all its inter-relationships is liable to be hidden under an account book when the moment arrives to add up the score and judge the performance of individual foreign units . . . ."
> (Rent Measuring Stick . . ., supra, at p. .)

Items which can affect the analysis are:

> ". . . a parent's guarantee of a loan . . . ."
> (Id., at p. 81)

> "Then there are the intagible items, such as the strategic considerations discussed earlier, whose worth or cost is even more elusive; to date they have universally been omitted

foreign subsidiary's book profits which do not take into consideration the substantial costs of developing a business

Fn. 25 cont'd

> from the initial formal calculations. For example, no manager of a major oil company would want to risk being left out of a potentially giant oil field that one of his company's rivals is exploring, even if the calculations of expected costs and returns might show a loss when discounted cash flow procedures are used. The risk of a rival finding a huge, low-cost oil field, and thereby gaining a superior long-run competitive position, is too big for the manager to take. Likewise, in manufacturing, there is a long-run risk that a rival will expand more rapidly and thereby achieve greater economies of scale." (Id., at p. 81)
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> "'In considering a new foreign investment, we take into account all profit over the marginal cost of all components shipped from our Michigan factory to the foreign plant. But later, when we report the profit or loss of the subsidiary, we use a standard intercompany price

and products which for small incremental costs can be produced very profitably (using separate account by a new subsidiary.26/

Fn. 25 cont'd

> that is based on average costs plus a profit.'" (Bent Measuring Stick . . ., supra, at p. 84.)

In the transfer and valuation of used equipment that had little value on the market,

> ". . . the incremental costs to a parent of providing services for a subsidiary usually are quite low; but the value to a subsidiary can be substantial." (Id., at p. 84.)

26. The San Diego Union (Aug. 14, 1982, p. C-9) reported that Oak Industries is shifting production of its most sophisticated product lines to Taiwan. Its spokesperson stated, "As long as we've been in Taiwan - 20 years or more - it has always been our practice to get production started here [in the U.S.], work out the bugs and then take a 99.9% perfected product to Taiwan."

CCA's evidence on ROI totally ignores the unitary nature of the business. It is disputed, was rejected by the California courts and should not be considered here.

CCA's arguments do not impeach the formula apportionment or establish that California has taxed more income of CCA's unitary business than is reasonably related to CCA's substantial business activity (property, employees and sales) in California.

IV

THE COMMERCE CLAUSE DOES NOT REQUIRE REVERSAL

CCA contends that (1) California's formula apportionment here results in taxation of income also taxed by foreign countries (AB pp. 21-27), and (2) prevents the federal government from speaking with one voice in foreign policy. (AB 27-36), both alleged in violation of the Commerce Caluse. Both concepts are taken from language in Japan Line Ltd. v. County of Los Angeles (1979) 441 U.S. 434 (hereinafter "Japan Line") FTB submits that the Japan Line rulings are inapplicable to this case and facts properly before this Court show neither double taxation nor interference with foreign policy.

A. Here No Tax is Imposed on Foreign Commerce

CCA is a Delaware corporation with its headquarters in Illinois. It

does business in California. In addition, CCA owns a number of subsidiaries which are incorporated in foreign countris and do business in foreign countries. California has assessed a tax against CCA, but it has neither asserted nor assessed a tax against any of CCA's foreign subsidiaries. Under the unitary business principle, California has included the property, payroll, sales and net income attributed by CCA to its foreign subsidiaries under CCA's separate accounting methods in the formula used to determine the amount of income properly attributable to California, because the subsidiaries are part of CCA's unitary business.

If CCA could establish that its foreign subsidiaries were not part of its unitary business, California would not require their inclusion in the combined

report. The apportionment method used was an effort by California to reach that income, and only that income, which was earned or properly attributable to activities within its borders. California, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the process conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in the record, reached, and was meant to reach, only the profits earned within the state. (Underwood Typewriter v. Chamberlain, supra, 254 U.S. 113; Hass, Ratcliff, etc., supra, 266 U.S. 271.)

CCA averaged over $10 million in California payroll, $15 million in property and almost $30 million in sales in California (J.A.Ex, pp. 2,4,6) in each

year in issue, for the government services to which California has requested about $200,000 per year in tax based on CCA's California income. This does not tax extraterritorial values. The tax totals only 6% of the California sales, a reasonable payment for the substantial services provided by the state by any standard.

This case taxes a domestic corporation doing substantial business here. It taxes no foreign business or instrumentality. Japan Line is totally foreign to the case at bench. In Japan Line the tax was directly on a container, an instrumentality which was moving in foreign commerce. It was owned by a Japanese Company. The property tax under discussion in Japan Line was directly on a foreign instrumentality moving in foreign commerce which "remain outside Japan only so long as needed to complete their international

missions." (Japan Line, supra 441 U.S. at p. 452.) The Japan Line decision stated,

> "The question here is a much more narrow one, that is, whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State." 27/

Japan Line itself thus severely restricted its application to a situation not present here. In Mobil this Court reiterated the distinction which makes Japan Line inapplicable to income taxation of unitary businesses.

> "Appellant's attempted analogy between this case and Japan Line strikes us as forced. That case involved ad valorem property taxes assessed directly upon

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27. "Accordingly, we do not reach questions as to the taxability of foreign-owned instrumentalities engaged in interstate commerce or of domestically owned instrumentalities engaged in foreign commerce." (Japan Line, at p. 444.)

> instrumentalities of foreign commerce. As has been noted, the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax." (Mobil, supra, 445 U.S. at p. 448.)

Japan Line itself said that multiple tax and impairment of federal uniformity are additional considerations, when a "state seeks to tax the instrumentalities of foreign commerce." (Japan Line at p. 446.) Here California is taxing no instrumentality of foreign commerce.

B. CCA Has Not Proven Unconstitutional Double Taxation Here

Japan Line distinguished income taxation of a unitary business by formula saying,

> "In Moorman, the problem arose, not from lack of apportionment, but from mathematical imprecision in the formulae. Yet, this Court consistently had held that the Commerce Clause 'does not call for mathematical exactness . . .; only if the resulting valuation is palpably excessive will it

> be set aside. [Citations.] This case, by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist . . . ." (Id., at p. 455.)

In contrast the division of the income of a unitary business among the several taxors is necessarily a task of apportionment, whether by formula, attempt to reconstruct a fictional arm's length separate accounting, acceptance of the taxpayers own separate accounting, or otherwise. The Japan Line discussions of double tax were not intended to apply here.

The Japan Line court discussed and approved its earlier Moorman decision which recognized that different methods of apportionment which could result in multiple taxation are permitted by the Commerce Clause. (441 U.S. at p. 455.) It noted, however, that Japan Line

> ". . .concerns foreign commerce. Even a slight overlapping of tax --

> a problem that might be deemed de minimis in a domestic context -- assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." (Id., at p. 456.)

As shown above, here California is merely taxing CCA, a domestic corporation. Unlike Japan Line, there are no "sensitive matters of foreign relations and national sovereignty" involved in determining the amount of income taxable by California to CCA.

In the field of income taxation (unlike property taxation) taxation of the same income at both state and federal levels is specifically permitted. "Concurrent federal and state taxation of income, of course, is a well established norm" (Mobil, supra, 445 U.S. at p. 448.) CCA has not attempted to show any state

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level income tax other than California's.[28]

Multiple taxation at a federal (country) level does not invalidate California's tax. In practice, the United States gives tax credits for taxes paid to foreign countries to mitigate (if not eliminate) such national level double taxation. Where U.S.A. has already given a credit for a foreign income tax, the result should be the same as if both California & U.S.A. had originally taxed the same income.

Where a credit has been given once (by U.S.A.) for a foreign income tax,

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28. California taxed about 8% of the unitary income. The foreign countries taxed less than one-third. (AB p. 17.) Less than half of CCA's unitary income has been taxed by California and the foreign countries (even using the evidence which has been rejected by the trial court and is not properly before this Court). CCA has not properly shown any actual double taxation or any reasonable risk of it, (except by both U.S.A. and California perhaps.)

allowing a second credit against California's would be totally unjustified.[29] No unconstitutional multiple tax results from allowing both a federal and state level tax on the same income.

Risk of double taxation of income is inevitable because there is, in fact, not uniformity of tax laws (let alone in their application.) Only if absolutely identical income tax laws were identically applied could double tax be certainly avoided. The record shows no such identical tax laws between any two countries (let

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29. Assume a taxpayer paid $5 foreign country tax and $20 U.S. tax (minus $5 credit), and $7 California tax, he would end up paying $5 foreign, $15 U.S. and $7 state level tax. If California were required to avoid double tax he would pay $5 foreign, $15 U.S. and only $2 state level. But if he paid no foreign tax he would pay $20 U.S., and $7 California taxes. A tax credit should be allowed only once, i.e., against federal income tax.

alone as to all of them.) Nor do we believe it can. In this writer's experience, income tax laws vary substantially from country to country both as to income taxed and deductions and credits allowed. CCA concedes that even the accounting methods (by which the income and deductions are calculated) vary from country to country. There is no such thing as a uniform "arm's length" method. Indeed, U.S.A. made no "arm's length" adjustments in CCA's income for payments (or lack thereof) by its subsidiaries which were not full value for services rendered by CCA. (J.A. pp. 78-79,¶ 151.) This shows both non-uniformity in application and inadequacy of the so-called arm's length method. The fact that this Court has no control over the methods of calculating tax used in foreign countries does not deprive the United States or any

state of the right to tax a fair share of the income of a multinational unitary enterprise.

CCA has proven no unconstitutional double taxation.

> "Appellant's reasoning tracks the rationale of Japan Line, that is, that separate accounting is required because apportionment necessarily entails some inaccuracy and duplication. This inaccuracy may be tolerable for businesses operating solely within the United States, it is said, because this Court has power to correct any gross overreaching. The same inaccuracy, however, becomes intolerable when it is added to the risk of duplicative taxation abroad, which this Court is powerless to control. Accordingly, the only means of alleviating the burden of overlapping taxes is to adopt an allocation rule. . . .
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> ". . .[N]othing about the logic of Mobil's position is limited to dividend income. The same contention could be advanced about any income arguably earned from foreign commerce. If appellant's argument were accepted, state taxing commissions would face substantial difficulties in attempting to determine what income does

or does not have a foreign source."
(Mobil, supra, 447 U.S. at pp. 446-447.)

C. CCA Has Not Proven Interference in Violation of the Commerce Clause With Foreign Relations

As has been pointed out already, California is simply here taxing a domestic corporation. No foreign sovereign has any legitimate interest or concern with California's taxation of CCA. Nor do those in the federal government who handle foreign relations.

The Commerce Clause provides that "the Congress shall have the power . . . to regulate commerce with foreign Nations . . . ." (U.S. Const., art I, § 8, cl. 3.) The Congress has expressed its foreign policy on use by states of formula apportionment of income of multinational unitary businesses. It has rejected all attempts to limit its use.

Particularly, the Senate even rejected a clause in a treaty with Great Britain which would have stopped use of formula apportionment only where British corporations had no contact with U.S.A. except through a subsidiary, but would have continued to permit it here and in all other cases. (Reservation of Art. 9(4) of the U.K. Convention for Avoidance of Double Taxation.)

This Court has recognized that absent action by Congress, formula apportionment does not interfere with federal foreign policy.

> "Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income. [Citations.] Legislative proposals have provoked debate over issues closely related to

> the present controversy. See, e.g., New York State Bar Assn. Tax Section Committee on Interstate Taxation, Proposals for Improvement of Interstate Taxation Bills (H.R. 1538 and S. 317), 25 Tax Lawyer 433 (1971). Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so." (Mobil, supra, 445 U.S. at pp. 448-449.)

To the extent that the actions of the executive branch should be considered,[30] during the period in issue, formula apportionment was clearly considered proper. Subsequent policies should not affect this case. However, by notice dated December 20, 1979, the

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30. There is nothing on this properly before this Court.

Department of State stated to the Ambassador of the Netherlands that, "This Department is not in a position to conclude that [formula apportionment involving a Dutch company and U.S. subsidiaries is] inconsistent with either the standards set forth in the treaty or general principles of international law."

The Solicitor General has, in the pending Chicago Bridge & Iron (CBI) case No. 81-349, expressed concerns about situations involving foreign businesses headquartered abroad. He conceded in oral argument that formula apportionment of multi-national unitary business income "does not violate any provision of any particular treaty." (Apr. 19, 1982, RT p. 18.) Various attorneys for the federal government are too often diverse in their opinions. (See Sullivan v. United States (1969) 395 U.S. 169, 185 fn. 2.)

The Solicitor General does not dictate what is the policy of this country on foreign relations. The Executive Branch has specifically indicated its acceptance of the states' use of the unitary business principle in its negotiation of Conventions to Prevent Double Taxation and Friendship Commerce and Navigation Treaties. With respect to the Convention between the United States and the Soviet Union for the Avoidance of Double Taxation, the Treasury Department stated:

> "With respect to the Soviet Union, the taxes and dues covered by the Convention are defined in subparagraph (a) of paragraph 1 as those provided for by the All-union legislation of the Soviet Union. The term "All-Union legislation" is not meant to refer to a specific law or code but is a generic term covering legislation at the national level that applies throughout the Soviet Union. The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, in

> keeping with past U.S. policy the taxes of the state and local governments of the United States are excluded from the scope of the Convention, except for purposes of Article X (Non-discrimination).

Standard Friendship, Commerce and Navigation Treaties contain general language dealing with the subject of taxation, including language providing the contracting states "shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to territories "of the taxing authority]" on citizens of the foreign country. (FCN Treaty with the Netherlands, Art. XI ¶ 4.) Department of State annotations explaining the standard treaty language clearly shows that formula apportionment by states is anticipated and acceptable.[31/] We have

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31. A State Department study in 1980 explained the terms "reasonably allocable or apportionable" in footnotes.

fn. cont'd

found no restrictions on any country's power to tax its own citizens (including domestic corporations like CCA) in any way it chooses. Indeed, the Department of State

Fn. 31 cont'd.

> "This provision provides an elementary, although incomplete, safeguard against double taxation by stipulating that taxes shall be imposed on only that portion of a nonresident alien or alien corporation's income that is truly representative of the income or profits derived from operations within the taxing country. The intent is to prevent taxation of global income. It does not necessarily preclude taking into account the entire income, capital and property of an enterprise,' wherever situated, as, for example, in determining the rate of tax. It does seek to prevent the ascertainment or measurement of the tax base, to which such rate is to be applied, on the basis of what is outside the country.
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> "Article XI (4) does not attempt to provide a set formula by which the allocation or apportionment shall be made. It takes into consideration the accounting complexities and

has argued that FCN Treaty provisions do not apply to companies incorporated in U.S.A. (See Sumitomo Shaji America, Inc. v. Avagliano (June 15, 1982) 50 U.S.L. Week 4643, 4645.) This Court also noted in

Fn. 31 cont'd/

> and problems of value judgment that are unavoidable, for example, in attempting to determine a reasonable allocation for a large multinational corporation. No single formula for this calculation has been agreed on. There are a variety of systems that meet the test of reasonableness as that test has come to be applied in United States jurisprudence. The various states have adopted a variety of tax bases which have received the sanction of the courts, including gross product, net sales, turnover, amount of property held in the State, and combinations of these various bases. The crucial element is that some test be applied and that it be 'reasonable.' The intent in employing that term by courts in this country. For the relationship of State actions in this field to the overall question of the States' treatment of 'foreign' and alien corporations, see Article XXII(4).

Sumitomo that the interpretations of similarly worded FCN Treaties may vary because of different negotiating histories. (Id., at p. 4646, fn. 12.) Thus, a thorough examination of all negotiations and treaties and other documents pertaining to the "one voice" assertions must preceed any conclusion that U.S.A. has adopted some so-called "arm's length" method as the exclusively permitted means of taxing income of businesses engaged in foreign commerce.

Fn. 31 cont'd

> "The term 'allocable' is considered as assigning or applying a share of total income on a percentage basis, which conceivably could be somewhat arbitrary and uneven in proportion.
>
> "The term 'apportionable' is considered as implying an equal division among the various elements involved. The two terms, taken in conjunction, are intended to cover all the various methods, proportionate or otherwise, by which a reasonable tax base might be determined."

With respect to both of the state taxes involved in Washington Rev. Dept. v. Stevedoring Assn. (1978) 435 U.S. 734 and Michelin Tire Corp v. W. L. Wages (1976) 423 U.S. 276, this Court stated:

> "It did not usurp the Federal Government's authority to regulate foreign relations since it did not fall on imports as such because of their place of origin. [Citation.] As a general tax applicable to all property in the State, it could not have been used to create special protective tariffs and could not have been applied selectively to encourage or discourage importation in a manner inconsistent with federal policy.
>
> " . . . . . .
>
> ". . .[T]he tax does not restrain the ability of the Federal Government to conduct foreign policy. As a general business tax that applies to virtually all businesses in the State, it has not created any special protective tariff. The assessments in this case are only upon business conducted entirely within Washington. No foreign business or vessel is taxed. Respondents, therefore,

> have demonstrated no impediment imposed by the tax upon the regulation of foreign trade by the United States." (Stevedoring, supra, at pp. 753, 754.)

Similarly here, CCA has not demonstrated any impediment on federal regulation of foreign trade or any Constitutional violation.

* * * * *

V

AMICI SUPPORTING APPELLANT SHOW NO UNCONSITUTIONALITY

Because of space limitation, response to much of Amici arguments is integrated into the preceeding responses to appellant's brief. Most factual matter referred to by Amici supporting appellant is not properly before this Court and should be ignored; however, even considering it, no unconstitutionality is shown.

Specific comment is made on briefs of Firestone, EMI and Shell Petroleum N.V. ("SPVN") because each has litigation now pending in California courts.

1. Firestone, like CCA, is simply an American-owned and based multi-national enterprise conducting a unitary business (producing rubber products and rubber) through subsidiaries. It makes basically the same arguments as CCA.

2. EMI is a U.K. corporation doing business in U.S.A. solely through a wholly-owned subsidiary, Capitol-EMI. California has included a unitary recording business in its formula when taxing Capitol-EMI. EMI's primary argument, that international law and custom prevents use of formula apportionment, is directly refuted by Congress' recent rejection of Article 9(4) of the U.K. Convention which would have created the insulation of British parent corporations from combination by states' with their unitary American subsidiaries.

3. It is asserted in the amicus curiae brief of Shell Petroleum N.V. that worldwide combination "can have particularly spectacular distorting effects" where the foreign company is the parent and the operations of a domestic subsidiary are relatively small in comparison with overseas operations.

(Brief A.C., Shell Petroleum, pp. 9-10.) SPNV cites by way of illustration the FTB's treatment of two of its subsidiaries, Scallop Nuclear, Inc. and Shell Oil Company, which has been challenged by SPNV in Shell Petroleum N.V. v. Mary Ann Graves, et al., No. C 81 4302 MPH (N.D.Cal.). On August 10, 1982, the District Court dismissed SPNV's action on the grounds that SPNV lacked standing to sue and that the controversy was not ripe for decision. An appeal to the Court of Appeals for the Ninth Circuit (Docket No. 82-4535) was filed by SPNV on September 3, 1982.

SPNV's illustration of the "spectacular distorting effects" of worldwide combination is itself a distortion of the facts in the Shell case. As of the present time, the FTB has not sought to tax Scallop Nuclear on $46,000,000 of apportioned income, as SPNV claims; in fact, the FTB has issued

no assessments at all against Scallop Nuclear. (See Complaint ¶32 (N.D. Cal. Nov. 4, 1981.) Proposed assessments for six of ten years under audit were issued against Shell Oil, but only after officials of that company not only refused to furnish information on Shell's operations relevant to the question of unity, but also refused to extend the statute of limitations applicable to a reassessment of taxes. (See Kashiwagi Aff. ¶¶ 13-15; Watson Aff. ¶4 (N.D. Cal. Apr 19, 1982.) Under the circumstances, the FTB auditor assigned to Shell Oil was forced to protect the revenue by issuing proposed assessments in which all doubts were resolved against the taxpayer. (Kashiwagi Aff., supra, at ¶ 15.) As a result of pending administrative proceedings, multimillion dollar adjustments already have been proposed. (Watson Aff., supra, at ¶ 7.)

In view of the above facts, the District Court held that the controversy in Shell was not ripe for adjudication because (1) no tax assessments have been issued against Scallop Nuclear, and (2) though proposed tax assessments for some of the years in question have been issued against Shell Oil, such assessments are still in the process of administrative review. In ruling on the question of standing, the District Court rejected the contention of SPNV that cited provisions of the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and the Netherlands (which provisions refer to "nationals and companies of the [Netherlands]" apply to the taxation of a U.S. subsidiary

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of a Netherlands parent.[32] The court stated:

> "It is clear that a company of the Netherlands which itself transacts business in the United States falls within the zone of interests sought to be protected by the Treaty; but it is also clear from Sumitomo Shoji that a U.S. corporation and its foreign parent are not mere extensions of each other, for Treaty purposes."
> (Memorandum Decision and Order, p. 10 (N.D. Cal. Aug. 5, 1982.)

The District Court concluded that neither the FCN treaty with the Netherlands nor the U.S.-Netherlands Double Taxation Convention of 1948, as amended, vests rights in Netherlands shareholders of a domestic corporation to redress an

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32. The Government of the Kingdom of the Netherlands has made the same contention both in the amicus curiae brief filed in this Court and in an amicus curiae brief filed in the Shell case. (See Memorandum of the Government of the Kingdom of the Netherlands as Amicus Curiae (N.D. Cal. April 19, 1982.)

alleged injury to the corporation.

CONCLUSION

Most of the factual matter relied on by appellant (and its Amici) is not properly before this Court and should not be considered. However, even considering such improper "evidence" no unconstitu - tionality, overpayment of tax or any ground for reversal has been shown.

The facts show substantial technical, managerial and financial services as well as capital assets and raw materials were furnished by CCA to its subsidiaries which are not adequately reflected in separate accounting figures. The foreign subsidiaries were part of CCA's unitary business. CCA's reliance on separate accounting approaches which ignore the integration and interdependence within a unitary business fails to show any distortion or extra territorial

taxation by formula apportionment. No due process violations are shown.

Nor have Commerce Clause violations been shown. CCA has proven no "double taxation" here; absence of international uniformity of accounting methods, tax laws and their application makes some double taxation of unitary multi-national enterprises inevitable; neither this nor taxing the same income at both state and national levels is constitutionally prohibited. Congress, the State Department and this Court have all approved international use of formula apportionment; it does not interfere with federal conduct of foreign

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relations; especially here where the taxpayer is a domestically incorporated and owned taxpayer.

The judgment should be affirmed.

Respectfully submitted,

GEORGE DEUKMEJIAN,
Attorney General

NEAL J. GOBAR,
Deputy Attorney General

Attorneys for Appellee,
Franchise Tax Board

Appendix A

MANAGEMENT THEORY:
SELECTED EXCERPTS

THE DECENTRALIZED PATTERN

[Excerpts from: John Pfiffner and Frank Sherwood, Administrative Organization, Prentice-Hall, Inc., Englewood Cliffs, N.J., 1960, pp. 189-196.]

The contemporary trend in large-scale organization is toward decentralization, but we must realize that decentralization is several things to different people. There are those who view it entirely in terms of decision-making; others see it from the standpoint of geographical dispersion of plants and installations; and still others approach it as a philosophy of corporate life, a set of organization values with sociological, psychological and spiritual facets.

Although the current wave of conversions to the "gospel" of decentralization seems to have started during and after World War II, there was a flurry during the 1920's marked by the emergence

of perhaps the greatest of the prophets, Alfred P. Sloan, Jr., and his enduring monument, General Motors.

II THE DECENTRALIZATION PATTERN IN OUTLINE

An overview in outline at this point may give the reader an understanding of the whole pattern of decentralization before we proceed to a fuller discussion of its parts.

I. The Formal Structure
   - A. A flat job-task pyramid
     1. Minimize number of horizontal levels
   - B. Distinguish between corporate and production levels
     1. Corporate level keeps out of production
     2. Establish semi-autonomous subsidiary corporations or divisions as the principal

operating units

C. Staff-and-line

1. Structure formal authority according to the staff-and-line model postulated in the preceding chapter

D. Set up organization planning as an instrumentality of dynamic growth and change.

II. Executive Behavior

A. Corporate executives

1. Major efforts devoted to planning, policy-making and evaluation of results

2. Refrain from that type of interference in current production matters which weakens subordinates

* * *

3. Set broad goals and targets

4. Control by remote feedback rather than immediate supervision

B. Production Executives

1. Function as autonomous head of own unit
2. Operate on flexible budget making executive virtually an entrepeneur; cost centers, allocating profit-and-loss, extend down into the plants
3. Make and implement policy subject to guide lines established at the corporate level
4. Delegate and then absorb heat generated by subordinates' errors
5. Plan production goals and controls by feedback

6. Generate atmosphere of self-reliance within a framework of freedom in which the main sanctions are results

III. Policy and Decision

A. Board guide lines are established at corporate level

B. There is a policy continuum in which each subordinate level determines policy in line with that set by superior echelons

C. Decisions are made at the lowest level consistent with the situation

D. Decisions are arrived at only after completed staff work and consultation, but the responsibility for decision

resides with the appropriate executive

E. The superior behaves in such a manner as to encourage subordinates to make decisions, parrying attempts to evade responsibility

IV. The Social Climate

A. Relaxed freedom within the rules of the game

B. Communication is two-way, oblique, and horizontal

C. Democratic consultation and interaction without undermining the essential needs of leadership and discipline

D. Individual self-expression and self-development are encouraged within the limits imposed by organization's resources and needs

III THE DECENTRALIZATION PATTERN IN DETAIL

The Formal Structure

Two general approaches. There are in general two ways of decentralizing an industrial structure. One is by leaving the decentralized units as integral divisions, there being only one corporation. In general this is the policy followed by General Motors. The other is to decentralize by the organization of subsidiaries, or affiliate companies. The Standard Oil companies have tended to follow the latter method.

Three bases of decentralization. Smith's study found three general types of decentralized structure in American industry: (1) by functions; (2) by geographical regions; and (3) by product divisions. Firms organized by function tend to have one main product. In them

the decentralized factory manager and sales manager each report to separate functional executives at headquarters, as would other functional people, such as finance. This type of organization has three vertical levels, and the people working in it seem to be less confused about status because it is clear to whom they report.

In the second, an organization based on geographical decentralization, everyone reports through the regional manager. Functional lines to headquarters are purely staff, similar to the line-and staff model postulated in the previous chapter. Such organizations tend to have four levels. In spite of the fact that this is the type of organization postulated by our model for large comapnies with diversified products, Smith points out that it seems usual "to have strong differences of opinion between the headquarters

officers, on the one hand, and the branch officers, on the other, as to who should have authority to do what." This is only one more example of the fact that the decentralized way of life may not be the easiest one.

Organization by product line is represented by the Ford Motor Company, General Motors, and Du Pont. In each case a major division is devoted to making and selling a single product. Each division is organized as an independent unit and the structure of the field units may be functional, geographical, or a mixture of the two. Committees at the corporate level work toward desirable standardization and uniformity.

FEDERAL DECENTRALIZATION

[Excerpts from: Peter F. Drucker, Management: Tasks, Responsibilities, Practices, Harper & Row, New York, 1974, pp. 572-579.]

In "federal decentralization" a company is organized in a number of autonomous businesses. Each unit has responsibility for its own performance, its own results, and its own contribution to the total company. Each unit has its own management which, in effect, runs its own "autonomous business."

Federal decentralization (as has been mentioned earlier, in Chapter 41) was first worked out, though only crudely, by Pierre S. de Pont in 1920 in the reorganization of the family-owned Du Pont Company, which had outgrown, during World War I, an older functional structure. When Pierre S. du Pont, shortly thereafter, took over the presidency of General Motors, which was

then in desperate trouble, he found that Alfred P. Sloan, then GM's executive vice-president, had arrived at a similar, though far more polished version. Sloan's "decentralized operations with centralized policy control"—put into effect during 1921-22—became the prototype of decentralization. Among the many imitations and adaptations, the one made in 1950-52 for the reorganization of the General Electric Company became, in the years of the "management boom," the standard model worldwide.

* * *

The Strengths of Federal Decentralization

Of all design principles available so far, federal decentralization comes closest to satisfying all design specifications. It also has the widest scope. Both operating work and innovative work can be organized as decentralized

autonomous businesses. And while top management can obviously not be set up as an autonomous business, federal decentralization of the business, if done properly, makes for strong and effective top managements. It frees top management for the top-management tasks.

The Requirement of
Federal Decentralization

Decentralization must not create a weak center. On the contrary, one of the main purposes of federal organization is to strengthen top management and to make it capable of doing its own work rather than be forced to supervise, coordinate, and prop up operating work. Federal decentralization will work only if the top-management job is clearly defined and thought through.

* * *

In other words, there must be a kind of "supremacy clause" reserving

to central management the decisions that affect the business as a whole and its long-range future welfare, and allowing central management to override, in the common interest, local ambitions and pride.

Specifically, there must be three reserved areas if the business is to remain a whole rather than splinter into fragments. Top management, and top management alone, can make the decision what technologies, markets, and products to go into, what businesses to start and what businesses to abandon, and also what the basic values, beliefs, and principles of the company are.

Second, top management must reserve to itself the control of the allocation of the key resource of capital. Both the supply of capital and its investment are top-management responsibilities which cannot be turned over to the autonomous units of a federal organization.

The other key resource is people. The people in a federally organized company, and especially managers and key professionals, are a resource of the entire company rather than of any one unit. The company's policies with respect to people and decisions on key appointments in the decentralized autonomous businesses are top-management decisions—though of course, autonomous business managers need to take an active part in them. And a decentralized company needs to have a strong, respected, and senior executive in top management who is the company's conscience with respect to people.

Top management in a decentralized structure has to be separate. It cannot also run any of the autonomous businesses no matter how big or important they are.

Appendix B

CONTAINER CORPORATION OF AMERICA FORMER CCA EMPLOYEES WORKING FOR FOREIGN SUBSIDIARIES

[Exhibit D to Stipulation of Facts in Evidence]

Name, company, position, and date foreign employment commenced.

Frank Angeles	Cartoenvases de Mexico, Mexico City Art Director - D September 1962
Otto H. Atkinson	Cartoenvases de Mexico, October 1963
Louis M. Crandall	Carton y Papel, corrugated Carton y Papel, Reforma Division Manager - D August 1963
Donald D. Hartman	Carton y Papel, Reforma General Manager - P October 1958
John T. Hutton	Carton y Papel, Los Reyes General Manager - P May 1963
Melvin L. Johnson	Carton y Papel, Los Reyes General Manager - P December 1960
Carl Philhower	Carton y Papel, Cerro Gordo Plant Manager - P November 1958

Ernest A. Robinson	Cartoenvases de Mexico, Mexico City General Manager - D July 1959
Stanley B. Tamkin	Carton y Papel, Reforma Vice President - C September 1959
William D. Thorpe	Carton y Papel, Corrugated Plant Manager - P February 1961
Epigmenio Guzman	Carton y Papel, Corrugated April 1961
Ernest W. Briggs	Carton de Colombia, Cali Staff Engineer - P January 1966
Francis J. Sauer	Carton de Colombia, Cali General Manager - P April 1962
T. J. Hosted	Carton de Colombia, Cali Controller - P May 1965
Edward N. Jacobs	Carton de Colombia, Cali Director of Manufacturing - D August 1950

Stanley Karpinski	Cartones Nacionales, Valencia February 1961
Jerry Sanders	Fibras, Caracas Resident Manager - P April 1960
Donald C. Corse	Cartones Nacionales, Valencia Division General Manager - D September 1952
Robert F. Donegan	Union Grafica, Caracas Vice President - C April 1961
Gordon Healea	Cartones Nacionales, Valencia Plant Manager - P March 1964
John Manzella	Carton de Venezuela, Petare Division General Manager - D December 1955
Delos G. Morton	Cartones Nacionales, Valencia General Controller-C June 1959
Glendie E. Osborne	Carton de Venezuela, Petare Mill Manager - P January 1963

Robert G. Ridings	Cartones Nacionales Valencia General Manager - P August 1963
Russell W. Wilson	Union Grafica, Caracas Director of Marketing - D July 1962
Richard A. Witte	Europa Carton, Heppenheim General Manager - P September 1957

C - Corporate
D - Division
P - Plant

Appendix C

Source Variations Computed on the Basis of Taxable Income

On page 16 of Appellant's Brief, various figures are set forth by Appellant to demonstrate the amount of foreign income allegedly erroneously apportioned by California to itself and the United States. Appellee does not believe that Appellant's analysis is relevant in context of the unitary theory and in any event is not probative given the admitted inaccuracies of separate accounting data in this case. Nonetheless, the Court should be aware that Appellant's calculations are based upon financial or book income (profits on JA:E Ex A-1 through A-6) not on taxable income as defined by California. As a result, Appellant has overstated the alleged misapportionment. If the Court wishes to consider the arguments raised by Appellant in the context of consistent and correct figures,

respondent respectfully suggests the following substitutions:

	1963	1964	1965
	1,470,105	4,675,478	3,660,163
1. Worldwide income apportioned to California	3,355,141	3,835,868	3,704,499
2. Domestic income apportioned to California	3,243,891	3,323,252	3,316,892
3. Increase of 1 over 2	141,250	512,616	387,607

These figures were computed on the following basis:

The first set of figures were calculated by Multiplying the United States Apportionment Factors times Adjusted Unitary Business Income JA:E Ex A-7 and Subtracting United States Source Income.

The figures on 1. were calculated by multiplying California Worldwide Apportionment Factors times Adjusted Unitary Business Income JA:E Ex A-7.

The figures of 2. were calculated by multiplying California Domestic Apportionment Factors Times the Total of Unitary Business Income per Return and Federal RAR Adjustments JA:E Ex A-7.

The various items involved in these calculations are defined as follows:

California Domestic Apportionment Factors

CCA Calfornia Factors JA:E Ex A-2, A-4, A-6 ÷ CCA Factors JA:E Ex A-2, A-4, A-6

California Worldwide Apportionment Factors

CCA California Factors JA:E Ex A-2, A-4, A-6 ÷ CCA Factors JA:E Ex A-2, A-4, A-6 + Total Factors JA:E Ex A-1, A-3, A-5 (Property & Payroll) and Combined CCA Sales JA:E Ex A-2, A-4, A-6 + Total Sales JA:E Ex A-1, A-3, A-5

United States Apportionment Factors

CCA Factors JA:E Ex A-2, A-4, A-6 (Property & Payroll) and Combined CCA Sales JA:E Ex A-2, A-4, A-6 ÷ Denominator Figures for Worldwide Above

United States Source Income*

Unitary Business Income per Return JA:E Ex A-7 + Federal RAR adjustments JA:E Ex A-7

*An even more appropriate comparison would be Income Subject to Tax by the IRS Adjusted to a California Tax Base which equals Federal Taxable Income per Form 1120 JA:E

Ex A-7 + RAR Adjustments JA:E Ex A-7 + State Taxes Based on Income JA:E Ex A-7 + Interest on Government Obligations JA:E Ex A-7. On this basis, the first set of figures on page 16 of Appellant's Brief would be:

1963	1964	1965
961,922	2,464,394	(1,215,898)

Appendix D

Nos. 52818, 52828, 52903

IN THE SUPREME COURT OF ILLINOIS

CATERPILLAR TRACTOR CO.,
CATERPILLAR AMERICAS CO.,
CATERPILLAR CREDIT CORP.,
CATERPILLAR FINANCE CORP.,
and CATERPILLAR MACHINERY CORP.,

Plaintiffs-Appellants,
Cross-Appellees,

v.

ILLINOIS DEPARTMENT OF REVENUE,
et al,

Defendants-Appellants,
Cross-Appellees,

and

COCA-COLA COMPANY, et al,

Intervening Plaintiffs-
Appellants.

On Appeal from the Appellate
Court of Illinois, Third District,

No. 79-104

There Heard on Appeal from the
Circuit Court of the Tenth
Judicial Circuit, Peoria County
Illinois.

Case No. 78L5615

Honorable
Stephen J. Covey,
Presiding Judge

BRIEF OF AMICI CURIAE

EDWARD C. RUSTIGAN
DAVID K. STAUB
MARTIN G. ROSENSTEIN
Attorneys for Continental Illinois National Bank and Trust Company of Chicago, Anchor Hocking Corporation, Clark Oil and Refining Corporation, Marshall Field & Company, McDonald's Corporation, Nalco Chemical Company, The Northern Trust Company, The Richardson Company, and Zenith Radio Corporation,
Amici Curiae.

Of Counsel:

MAYER, BROWN & PLATT
231 South LaSalle Street
Chicago, Illinois 60604
(312) 782-0600

ORAL ARGUMENT REQUESTED

[The following pages contain only Argument I of the brief.]

ARGUMENT

I.

COMBINED REPORTING IS REQUIRED TO FAIRLY APPORTION INCOME OF A UNITARY BUSINESS

Where a unitary business is conducted through a number of separate corporations, each corporation in the group will generally maintain separate accounting records. Opponets of the combined method of apportionment argue that the existence of such separate records solves the problem of allocating specific items of income and expense to different segments of a unitary business. They conclude that apportionment on a separate basis (corporation by corporation) is the appropriate method for dividing the income of a multicorporate enterprise among the states in which it operates.

There are at least two basic reasons why apportionment on a separate

basis in unsound for a truly unitary business. First, apportionment on a separate basis would be extremely difficult, and often impossible, to administer fairly. Second, apportionment on a separate basis does not result in a fair distribution of profits and losses of individual members of a unitary business among all members of the group.

A. Apportionment on Separate Basis Cannot Be Policed

Any failure to maintain arm's-length dealings in transactions between members of a multicorporate unitary business will result in distortion of the income of the individual members. With combined reporting, the potential problem of distortion is eliminated by combining the income of each member of the unitary group prior to apportionment. If apportionment is made on a corporation by corporation basis, however, any distortion

is preserved. Thus, if apportionment on a separate basis is permitted, the Department must closely police all transactions between members of the unitary group to insure that the transactions are conducted at arm's length.

If apportionment on a separate basis is permitted, some taxpayers may be tempted to manipulate prices in order to reduce tax liability in the taxing state. Although a taxpayer is entitled to structure its transactions to reduce its tax liability, it may not do so by arbitrarily assigning non-arm's-length prices to its goods or services. Without combined reporting, the Department might be forced to sort through thousands of transactions to determine the proper income of a single unitary business.

While the overwhelming majority of taxpayers make every effort to comply with the tax laws, it is often very

difficult to determine proper pricing of intercorporate transactions and there will inevitably be many good faith disagreements between taxpayers and revenue collection agencies. Policing of transactions between related companies to insure that they are arm's-length is particularly difficult when there is a lack of competitive pricing information. In some instances, a product may be unique (e.g., a manuscript, motion picture, or master recording) and information on property of a similar type may not be very helpful in determining an arm's-length price. In other instances, a product may be transferred at an interim stage in the manufacturing process when no similar sale would be made by unrelated parties, and thus no arm's-length price would be available. Thus, even after the non-arm's-length transactions are identified, the Department may still have

difficulty in determining a proper arm's-length price.

The scope of the problem of policing transactions between related parties is shown by the myriad cases under Section 482 of the Internal Revenue Code, which allows the Internal Revenue Service to reallocate various items among separate corporations in order to clearly reflect the income of the corporations for Federal income tax purposes. One commentator has noted that such policing at the state level "would require an army of agents greater than the total number of agents employed by all the states and the Federal Government combined."*

Accordingly, permitting a unitary group of corporations to report

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*Keesling, A Current Look at the Combined Report and Uniformity in Allocation Practices, 42 J. Taxation 106 (1975).

income or a separate basis will create substantial administrative burdens for the Department and will prevent fair enforcement of the law. The Court should require combined reporting so that the Department will not be forced to rely on a hit-or-miss method of determining the amount of income attributable to Illinois.

B. Unitary Method Essential for Fair Allocation of Profits and Losses

Even if the state could determine that all transactions among members of a unitary group were conducted at arm's length, reporting the income of each corporation on a separate basis is still inappropriate for a unitary business. The cornerstone of unitary apportionment is the assumption that the various segments of a unitary business are interrelated and vital parts of the whole business. Even

though a portion of a unitary business may only break even or even be unprofitable on a separate basis, it may contribute to the profitability of the larger enterprise in numerous ways which may not be recognized under any separate accounting system.

The courts of several states have recognized that a unitary business is inseparable even where segments of the business are separately incorporated. The Supreme Court of California concluded in the leading case of Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947), that a California subsidiary corporation, engaged in selling merchandise, contributed to the profits of the whole unitary enterprise in the same way that a California branch contributed to the profits of the unitary business in Butler Brothers v. McColgan, 315 U.S. 501

(1942), i.e., by enabling the enterprise to obtain more favorable prices on its purchases. Thus, the court applied combined formulary apportionment to the business despite a finding that the subsidiary corporation's separate accounts were reasonable and accurate.

Contributions to a unitary enterprise may even be less tangible: a member of the unitary group may be an excellent training ground for management personnel who later work for another member of the group; a member of the unitary group may serve a role in attaining a "national" status for the unitary enterprise.

The impossibility of identifying, let alone quantifying, the contributions of a segment of a unitary business to the enterprise as a whole makes reporting on a separate basis undesirable. Thus,

combined reporting provides a better means of achieving the legislature's goal of an equitable method of apportionment.

II.

COMBINED REPORTING APPROPRIATELY STRESSES SUBSTANCE OVER FORM

Intervenors concede that formulary apportionment is proper under the Illinois Income Tax Act. However, they argue that where a unitary group member is a separate corporate entity, formulary apportionment should apply to that corporation separately. Amici Curiae contend that because of the interdependence of the entities which make up the unitary group combined reporting is essential to achieve a fair apportionment of income. This interdependence exists whether the unitary group is made up of corporate or noncorporate entities. Accordingly, formulary apportionment should apply on

a combined basis.

The application of formulary apportionment to each corporate member of a unitary group on a separate basis would elevate form over substance. Assuming that the enterprise is unitary, its tax liability should be the same whether it is structured (i) as a single corporation consisting of separate divisions, or (ii) as a multicorporate enterprise in the form of a parent corporation with separate subsidiary corporations. In applying formulary apportionment Intervenors would distinguish (i) from (ii). In situation (i), they would combine the separate divisions of the single corporation and apportion the divisions' income as a unit. Yet in situation (ii), Intervenors would treat the parent corporation and each of its subsidiaries separately. They would

apply formulary apportionment to the parent corporation on a separate basis and to each subsidiary corporation on a separate basis. The emphasis on structural form in Intervenors' argument is apparent.

The Illinois Income Tax Act should be interpreted so that the taxpayer's decision whether to operate his business as a corporation with divisions or a corporation with subsidiaries is made on the basis of economic and not tax considerations. Separate reporting might encourage some taxpayers to fracture their business into subsidiaries solely because of the advantage gained under the Illinois Income Tax Act.

The following example illustrates the consequences of ignoring the substance of the unitary enterprise and stressing its structural form.

EXAMPLE

Widget Corporation, Inc. is an Illinois corporation engaged in the manufacture and sale of widgets. Widget Corporation, Inc. has a separate unincorporated division, Western Widget Division, which conducts all sales operations for Widget Corporation, Inc. on the West Coast of the United States. Widget Corporation, Inc., also has a wholly-owned subsidiary corporation, Eastern Widget Subsidiary, which conducts all sales operations for its parent corporation on the East Cost of the United States.

The operations of Eastern Widget Subsidiary are identical to those of Western Widget Division. Neither Western Widget Division nor Eastern Widget Subsidiary manufactures widgets. Widget Corporation, Inc. manufactures all of the widgets which are sold by its division and corporate

subsidiary. Widget Corporation, Inc. engages in no sales operations on its own. It is assumed that Widget Corporation, Inc., its division and its corporate subsidiary constitute a unitary business. Western Widget Division and Eastern Widget Subsidiary are completely dependent on Widget Corporation, Inc. for the widgets which they sell.

In a given year, Western Widget Division and Eastern Widget Subsidiary each earn income of $100,000 on sales. Widget Corporation, Inc. earns no income since it sells at cost. (It is recognized that Widget Corporation, Inc. probably should not sell at cost since it normally would be entitled to a manufacturing profit. However, see the discussion of administrative problems in I.A. of the argument at page 8 above). Western Widget Division and Eastern

Widget Subsidiary each have property, payroll, and sales of $200,000, all of which is the result of sales operations outside Illinois. Widget Corporation, Inc. has $200,000 of property, payroll, and sales inside Illinois as a result of the location of its manufacturing facilities there. Table I summarizes the amounts set forth above.*

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*The apportionment formula under the Illinois Income Tax Act is a three factor formula based on property, payroll and sales. For purposes of simplification, this example treats the factors in the aggregate.

TABLE I—FACTS

	Income	Property Payroll Sales Inside Ill.	Property Payroll Sales Outside Ill.
Widget Corporation, Inc.		$200,000	
Western Widget Division	$100,000		$200,000
Eastern Widget Subsidiary	$100,000		$200,000

Under the combined method of reporting, formulary apportionment would apply to the income of the unitary group as presented in Table II.

TABLE II—Combined Reporting

Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division Eastern Widget Subsidiary			Income of Widget Corporation, Inc. Western Widget Division Eastern Widget Subsidiary
Illinois and Non-Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division Eastern Widget Subsidiary	X		

$\frac{\$200,000}{\$600,000}$ X $200,000 = $66,667 subject to Illinois Income Tax

Income of Unitary Group Subject to Illinois Income Tax = $66,667.

Table III illustrates how formulary apportionment would apply to the unitary group on a separate basis.

TABLE III—Separate Reporting

(1) Application of Formulary Apportionment to Widget Corporation Inc. and its unincorporated division, Western Widget Division.

$$\frac{\text{Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division}}{\text{Illinois and Non-Illinois Property-Payroll-Sales of Widget Corporation, Inc. Western Widget Division}} \times \text{Income of Widget Corporation, Inc. Western Widget Division}$$

$$\frac{\$200,000}{\$400,000} \times \$100,000 = \$50,000 \text{ subject to Illinois Income Tax}$$

TABLE III (Cont'd)

TABLE III—Separate Reporting
(Cont'd)

(2) Application of Formulary Apportionment to Eastern Widget Subsidiary.

$$\frac{\text{Illinois Property-Payroll-Sales of Eastern Widget Subsidiary}}{\text{Illinois and Non-Illinois Property-Payroll-Sales of Eastern Widget Subsidiary}} \times \text{Income of Eastern Widget Subsidiary}$$

$$\frac{\$0}{\$200,000} \times \$100,000 = \$0 \text{ subject to Illinois Income Tax}$$

Income of Unitary Group Subject to Illinois Income Tax = $50,000.

As Table III illustrates, apportionment of the income of the unitary group on a separate basis results in all of the income earned by Eastern Widget Subsidiary escaping apportionment under the Illinois Income Tax Act, even though the manufacturing facilities upon which this income depends are located within Illinois. On the other hand, all of the income earned by Western Widget Division is subject to the Illinois apportionment formula because it operates as a division of Widget Corporation, Inc. rather than as a subsidiary corporation. Hence, if the income of the unitary group is apportioned on a separate basis, Widget Corporation, Inc. will have benefited under the Illinois Income Tax Act simply by incorporating its East Coast sales operations into a separate corporation.

If the example were altered so that either (i) Widget Corporation, Inc. and Western Widget Division were located outside Illinois while Eastern Widget Subsidiary was located inside Illinois or (ii) Widget Corporation, Inc. was located outside Illinois while Western Widget Division and Eastern Widget Subsidiary were located inside Illinois, a greater Illinois tax liability would result under separate reporting than under the combined method.

The point of this example, however, is not to show that Illinois exacts a greater or lesser tax depending on which method is used. The respective parties would agree there is a difference. Amici Curiae merely wish to illustrate that, given the fact that formulary apportionment has been adopted in Illinois, basing the tax liability of a

group of interdependent and inseperable business activities on whether a particular activity is structured as a separate corporation places a wholly unwarranted emphasis on the structural form of the enterprise.

Courts in other states have recognized that the structural form of the unitary enterprise should not affect the apportionment of income and, therefore, have required use of combined reporting. See, Edison California Stores, Inc. v. McColgan, 183 P.2d 16, 21 (Cal. 1947); Coca-Cola Company v. Department of Revenue, 533 P.2d 788, 792-94 (Ore. 1974); Montana Department of Revenue v. American Smelting & Refining Company, 567 P.2d 901, 908-09 (Mont. 1977). Similar recognition has been accorded in legal commentary. Frank M. Keesling explains that the purpose of the combined

report is to assure that where a business is conducted both inside and outside the taxing state, the business' income will be apportioned in the same fashion whether the business consists of one corporation or multiple corporations. He notes that in both cases the income of the business is computed as a unit, apportioned by applying the appropriate formula, and the amount so apportioned is added to any nonbusiness income which the taxpayer derives from sources within the taxing state. Thus, in determining the amount of business income attributable to a particular state, "no advantage is obtained, and no detriment suffered, as the result of employing a number of corporations rather than one to operate a business," Keesling, A Current Look at the Combined Report and Uniformity in Allocation Practices, 42 J. Taxation

106 (1975).

Furthermore, the United States Supreme Court's recent opinion in Mobil Oil Corp. v. Commissioner of Taxes, 48 U.S. L.W. 4306 (March 19, 1980), reflects unwillingness to permit the structural form of a unitary enterprise to affect issues of taxation. In Mobil Oil, the taxpayer argued that the inclusion, by a non-domicillary state, of dividends received from the taxpayer's foreign subsidiaries and affiliates in the income tax base subject to apportionment violated the Due Process and Commerce Clauses of the United States Constitution. In the context of the taxpayer's due process challenge, the Court refused to draw any distinction on the grounds that the income was received in the form of dividends from separately incorporated entities rather than derived from

intracorporate divisions.* The Court stated:

> "Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. General Motors Corp. v. Washington, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives." 48 U.S. L.W. at 4310.

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*Amici Curiae acknowledge that the Court refused to decide whether the Due Process Clause requires combined reporting. 48 U.S.L.W. 4306, n. 15. However, Amici Curiae believe that the Court's distaste for arguments emphasizing form over substance bears noting.

The purpose of formulary apportionment under the Illinois Income Tax Act is to fairly and equitably attribute the income earned by a unitary enterprise to the business activities which it conducts within the State. Amici Curiae submit that fairness and equity cannot be achieved if a distinction is made merely because a segment of the unitary enterprise operates as a separate corporation.

CONCLUSION

In light of the foregoing policy considerations, Amici Curiae respectfully request that this Court affirm that portion of the decision of the Appellate Court which would require the combined method of reporting in the State of Illinois.

Respectfully submitted,

EDWARD C. RUSTIGAN
DAVID K. STAUB
MARTIN G. ROSENSTEIN
Attorneys for Continental Illinois National Bank and Trust Company of Chicago, Anchor Hocking Corporation, Clark Oil & Refining Corporation, Marshall Field & Company, McDonald's Corporation, Nalco Chemical Company, The Northern Trust Company, The Richardson Company, and Zenith Radio Corporation, Amici Curiae.

Of Counsel:
Mayer, Brown & Platt
231 South LaSalle Street
Chicago, Illinois 60604
(312) 782-0600

Appendix E

THE THEORY OF THE UNITARY BUSINESS PRINCIPLE

[Excerpt from International Division of the Income Tax Base of Multinational Enterprise, Publ. Multistate Tax Commission, Geoffry John Harley, 1981, p. 6.]

The unitary enterprise theory rests on economic analysis. Its focus is on the geographic locations of the comp nents of the multinational enterprise itself. It views a group of enterprises under common ownership as components of a single integrated business operation, arranged in a particular way purely to accommodate legal requirements. The central operational premise is that all parts are coordinated by a central management policy and structure which seeks to maximize profits over-all. Accordingly, intercorporate business is irrelevant and profit or loss is determined by transactions with third parties. The intercorporate transactions are

essential factors in producing profit, in the sense that without them, and the peculiar advantages associated with integrated enterprises, there would be no product at the end, but it is the profit itself that counts. The transactions up to the point of sale to the unrelated third party are irrelevant for tax purposes because profit or loss can only be determined when the entire enterprise completes the process of production.

The basic question addressed by the unitary method is how the overall profit of the enterprise is to be assigned, given the fact that separate tax jurisdictions do exist. The separate entity theory requires that profits be assigned to the particular units of the organization in each location. The unitary theory treats the units as being irrelevant; what counts is the extent of the profit

making activity in any given location, based on a measure of territorial contribution, The unitary method seeks to assess what factors of production were located in each country, measuring objectively how much labor was used, how much capital was employed, and where the sales took place. The formula, based on these factors, assigns income to each geographic location on these bases, dividing the entire group's total income among the jurisdictions in which the units happen to be located.